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SUBJECT: LIBERIAN DOLLAR'S DOWNWARD SLIDE PRESENTS FRESH HARDSHIPS FOR THE POOR

¶1. (SBU) SUMMARY: For the past three years, the Liberian Dollar (LD) maintained relative exchange rate stability, weathering double-digit inflation, ever-increasing import prices, and delayed revenue from lucrative mining and timber contracts, thanks to cautious monetary and fiscal policy. Yet, as exports fail to rebound and remittances continue to sag, the Liberian Dollar has depreciated 12 percent since May, and commercial bankers, currency traders and the International Monetary Fund fear an absence of fundamental demand for the LD points to an ongoing decline in value for the rest of the year. In an import-dependent economy such as Liberia, further LD depreciation weakens the purchasing power of lower-income consumers, who are the primary users of the local currency. However, it could also provide the political cover the Central Bank of Liberia (CBL) may require to implement reforms that would stimulate long-term demand for local currency, including local currency tax payments and ultimately issuance of government securities. END SUMMARY

Why the Sudden Crash?

¶2. (SBU) When Liberia relinquished a longstanding one-to-one peg to the USD in 1988, the LD buckled under fiscal profligacy, a collapse in exports, and political instability. Yet after President Sirleaf entered office in January 2006, the CBL maintained laudable exchange rate stability; the LD hovered between 58 and 62 to the U.S. dollar (USD) for over three years. However, in May the LD began its persistent descent, reaching a low of 73 to 1 USD on August 28. [Note: The LD stood at 71.5 on September 16, following a temporary uptick in demand for local currency to pay school fees. End Note.] Given that civil servant salaries in Liberia are paid in LD, this depreciation constitutes a 17 percent erosion in purchasing power for those who subsist on imported foodstuffs.

¶3. (SBU) Liberia sustained exchange rate stability throughout 2008, even as headline inflation peaked at 25 percent, and the global financial crisis put downward pressure on remittances, export and mining revenues, thanks to countervailing forces that buoyed the currency. Notably, the price of rubber, which constitutes over 85 percent of Liberia's export earnings, crested in mid-2008, and the rally continued in late-2008 when the GOL sold off USD to pay 35,000 civil servants two months' of salary arrears.

¶4. (SBU) A currency in the LD's situation, bolstered by anemic export demand and less than USD 60 million in foreign reserves, could not be expected to withstand the consequences of a global financial crisis for a long period. The LD now faces a double squeeze: the supply of foreign currency is tightening and the CBL lacks the monetary instruments to reign in growth in the domestic money supply.

Contributing Factors

¶5. (SBU) Factors that contribute to the excess demand for USD

include dwindling remittances, deteriorating terms of trade, and disappointing revenues from the extractive industries. International Bank-Liberia President Patrick Anumel estimates inbound remittances declined 20 percent in the second quarter, as members of the Liberian diaspora face job losses or straitened circumstances in their country of residence. At the same time, UNMIL peacekeepers are repatriating more money, while NGOs, themselves struggling with a shrinking donor base, are scaling down operations and downsizing large staffs once compensated in foreign currency. Further, a slump in rubber prices, delays in the advent of iron ore and timber exports and consumer demand for imported goods and services exacerbate a longstanding current account deficit. And the failure of cash-strapped concessionaires to disburse promised payments to the GOL stymies CBL efforts to reinforce foreign exchange reserves.

¶6. (SBU) At the same time, a political desire to address social inequities trumped the CBL's public commitment to exchange rate stability and inflation-busting. The GOL instituted a series of incremental increases in civil servant salaries from LD 1,000 to LD 5,280 in the past two years, while LD expenditures on social safety nets jumped 16 percent year on year, swelling the number of LD in circulation by 15 percent, according to CBL statistics. Given the absence of government securities, a weekly foreign exchange auction - which is limited to USD 500,000 - constitutes the only meager mechanism by which the CBL can absorb this excess liquidity.

How Low Will It Go?

¶7. (SBU) Foreign exchange dealers, commercial and central bankers, and the IMF share a belief that the Liberian dollar will trend

downward through the end of the year. Lawrence Appleton, President of the Money Changers Association of Liberia, IMF senior economist Alexander Deline, and Milton Weeks, Secretary General of the Liberia Bankers Association, predicted the LD could hit 75 by year's end, while a bearish Anumel forecast a downside of 80. Not surprisingly, bulls still reside at the central bank. Richard Dorley, director of research, policy and planning, believes the CBL will steady the currency at 72 to 1 USD. In any case, all agree that seasonal trends in currency markets make a further short-term depreciation inevitable, as local merchants import goods in advance of the holiday season.

A Currency that Nobody Wants

¶8. (SBU) Global financial crisis notwithstanding, the fundamental cause of Liberia's exchange rate malaise comes down to an absence of demand for the LD. Local currency comprises only 30 percent of the broad money supply, a rate of dollarization reinforced by government regulation, import demand and inflation expectations. The Ministry of Finance requires taxes to be paid in USD; the Ministry of Commerce and Industry fixes prices for cement, fuel and rice in USD; and importers purchase goods in USD. Merchants therefore adjust local currency prices to the USD cost and some merchants even quote prices only in USD, despite unenforced requirements to list prices in both currencies.

¶9. (SBU) Local currency functions narrowly as a unit of account in small transactions and as change for USD-denominated purchases. Employees of UNMIL, foreign embassies, NGOs, large concessionaires, and the country's thousands of rubber tappers receive paychecks in USD. Even the LD's role as a store of value is limited, as commercial banks report that higher interest rates on local currency savings accounts fail to entice depositors to convert their foreign currency accounts.

The Social Costs of a Weak Liberian Dollar

¶10. (SBU) Despite its limited role, the LD's depreciation causes mischief throughout the Liberian economy. The immediate victims of depreciation include civil servants and employees of small business

who are paid in local currency, petty traders who sell imported goods in the local markets, and the low-end consumers of goods and services whose modest purchasing power dwindles further each time the price of imported rice increases. However, the Liberian economy is so inured to chronic inflation, that even importers and those highly-skilled workers paid in USD are not insulated from the depreciation. Merchants vigilantly monitor daily exchange rates, and LD prices change regularly to reflect not only the current cost of currency, but the expected future depreciation. So, while consumers pay higher prices, importers bear greater transaction costs as they increase the regularity and reduce the size of each currency exchange. Rural Liberians, once insulated from the vicissitudes of Monrovia's import-oriented economy, also share the pain of ongoing depreciation, thanks to improving transportation and distribution networks that increase their access to imported goods.

¶11. (SBU) Given that Liberia lacks exporters who could benefit from an uptick in demand for their increasingly inexpensive goods, the only entity that stands to gain from the depreciation is the GOL itself. Businesses and citizens alike must pay taxes in hard currency, while the GOL's principal liabilities remain in local currency. For example, although the civil servant pay scale is denominated in USD, civil servants are paid in local currency, fixed for this fiscal year at a rate of 66 LD to 1 USD. So, only three months into the fiscal year, a minimum wage civil servant who ostensibly receives a monthly wage of USD 80 (LD 5,280) has suffered a 10% reduction in purchasing power.

COMMENT

¶12. (SBU) In the short-term, multilateral support and favorable commodity prices may avert a balance of payments crisis. There are signs that natural rubber prices may rally. The IMF is readying a USD 160.7 million (SDR 103 million) allocation to Liberia (Liberia's share of the IMF's $250 billion global package to offset the financial crisis), which would bolster the CBL's foreign assets, and steady the exchange rate for at least one year. Yet exogenous solutions are no long-term panacea for what ails Liberia's currency. Export diversification and a reversal of the chronic current account deficit are the only definitive guarantees of exchange rate stability, but these require years of sound investment policy, a strong commercial code, and updated infrastructure to nurture.

¶13. (SBU) A more immediate solution lies with the CBL, a chronically passive regulator, but one that may be energized by the political consequences of depreciation. While cautiously avoiding definitive pronouncements on a policy of de-dollarization, the CBL may be taking steps that would improve food security and steady the purchasing power of Liberia's most vulnerable. Governor Mills Jones has begun urging the Ministry of Finance to repeal the longstanding requirement that taxes be paid in USD, and is in the early stages of developing a strategy for selective issuance of short-term government securities after Liberia reaches HIPC Completion Point. The CBL also has a vested interest in financial deepening: as commercial banks expand services outside Monrovia, they can channel excess supply of local currency into loans to rural businesses and agricultural projects.

ROBINSON